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E.O. 11652: GDS

TAGS: ECON EAID EFIN MASS MPOL ET US

SUBJ: UPDATE OF ECONOMIC EFFECTS OF PROJECTED EPMG

MILITARY PROCUREMENT

REF: A) ADDIS 1181; B) A-17 OF FEB 5, 1975

SUMMARY: A RECENT EMBASSY/USMAAG UPDATE OF THE EPMG'S APPARENT INTENTIONS REGARDING MILITARY PROCUREMENT SUGGESTS THAT THE EPMG MAY BUY AS MUCH AS US\$300 MILLION WOTH OF MILITARY GOODS AND SERVICES DURING THE USFY 1975-79 PERIOD. IF REALIZED, THIS LEVEL OF PROCUREMENT PLUS THE EPMG'S OBLIGATIONS TO COMPENSATE NATIONALIZED FIRMS AND TO FINANCE ITS SHARPLY INCREASED DEVELOPMENT PROGRAM COULD PLACE ETHIOPIA'S FOREIGN EXCHANGE RESERVES UNDER SERIOUS PRESSURE IN TWO OR THREE YEARS AND WILL GREATLY INCREASE THE RISK OF A HIGH RATE OF INFLATION TOWARD THE END OF THIS PERIOD. END SUMMARY

1. THE EMBASSY, IN CONJUNCTION WITH USMAAG, RECENTLY COMPLETED AN UPDATE OF THE ECONOMIC IMPLICATIONS OF THE EPMG'S APPARENT INTENTIONS REGARDING PURCHASE OF US MILITARY GOODS AND SERVICES. REFS REPORT FINDINGS OF ORIGINAL ANALYSIS CARRIED OUT IN JANUARY. Owing to additional info regarding EPMG procurement plans and economic developments during the past six months, EMBASSY BELIEVE

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UPDATE OF PREVIOUS ANALYSIS WILL BE USEFUL IN CONSIDERING CURRENT
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AND FUTURE USG RESPONSES TO EPMG DESIRES TO PROCURE MILITARY ITEMS.

2. THE EPMG HAS INCREASED THE AMOUNT OF POSSIBLE MILITARY PURCHASES THROUGH FMS CASH AND CREDIT AS WELL AS DIRECT COMMERCIAL TRANSACTIONS BY APPROXIMATELY US\$100 MILLION. BASED ON RECENT LETTERS OF INTENT, MAJOR NEW ITEMS INCLUDE 2-C130'S (PROBABLY COMMERCIAL BUY), THREE ASHVILLE CLASS PG'S, F5E'S AND 2 1/2 TON TRUCKS. THE TABLE BELOW SETS FORTH THE ESTIMATED CAPITAL INVESTMENT, O&M AND INTEREST COSTS FOR THE PREVIOUS AND CURRENT PROPOSED PROCUREMENTS ON A CASH OUTLAY BASIS IN US MILLIONS. THE SAME ASSUMPTIONS (SEE REFTEL) WERE APPLIED TO DEVELOPING THE CURRENT COST FIGURES AS WERE USED TO DEVELOP THE ORIGINAL ONES.

MILITARY PROCUREMENT - CASH OUTFLOW

(US\$ MILLIONS)

	FY-76	*6-76	*6-77	FY-78	FY-79	TOTAL
PREVIOUS						
ESTIMATE						
(JAN 75)	6.4	57.4	39.1	44.2	46.7	193.8

CURRENT

ESTIMATE

(JUL 75)	15.4	78.9	65.3	84.6	48.8	293.0
(ACTUAL)						

3. ECONOMIC IMPLICATIONS. LOOKING FIRST TO THE FOREIGN EXCHANGE IMPACT, ETHIOPIA'S FOREIGN EXCHANGE RESERVES WERE APPROXIMATELY US\$300 MILLION AS OF JAN 1, 1975 OR ROUGHLY US\$50 MILLION BELOW OUR EARLIER PROJECTIONS (THIS DIFFERENCE IS PRIMARILY ACCOUNTED FOR BY THE HEAVIER THAN EXPECTED YEAR-END SURGE IN IMPORTS AND A STEEPER DECLINE IN BOTH EXPORT PRICES AND VOLUMES THAN HAD BEEN ANTICIPATED). RESERVES HAVE BEEN INCREASING MARGINALLY OVER THE PAST FEW MONTHS, HOWEVER, AND AS OF MAY 31 WERE APPROX US\$310 MILLION. ALTHOUGH VERY DIFFICULT TO PREDICT OWING TO UNSETTLED POLITICAL AND ECONOMIC CONDITIONS, THE EMB CONTINUES TO PROJECT A US\$50 MILLION SURPLUS IN ETHIOPIA'S BOP FOR CY 1975 EXCLUSIVE OF MILITARY PROCUREMENT AND COMPENSATION FOR NATIONALIZED BUSINESSES BUT INCLUDING THE INCREASES IN DEVELOPMENT EXPENDITURES. WE WOULD THEREFORE EXPECT A FOREIGN EXCHANGE RESERVE

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POSITION AT END YEAR CY 75 OF ROUGHTLY US\$350-360 MILLION ASSUMING NO MILITARY PROCUREMENT OR COMPENSATION TO FOREIGNERS. THIS FAVORABLE PROJECTION IS BASED ON THE SHARP UPTURN IN COFFEE PRICES AND THE SUBSTANTIAL LEVELS OF PUBLIC LONG-TERM CAPITAL INFLOWS. BOTH OF THESE COMPONENTS SHOULD REMAIN FAVORABLE FOR THE NEXT TWO OR THREE YEARS.

4. THE DEMANDS OF COMPENSATION FOR NATIONALIZED ENTERPRISES, HOWEVER,

MUST BE TAKEN INTO ACCOUNT. IT APPEARS THAT EHEPMG WILL SOON ISSUE ITS COMPENSATION DECREE AFTER WHICH AGREEMENTS ON COMPENSATION WITH NATIONALIZED FIRMS WILL BE NEGOTIATED. ALTHOUGH THE FULL FOREIGN EXCHANGE IMPACT OF COMPENSATION WILL PROBABLY NOT BE FELT THIS YEAR, IT CERTAINLY WILL BE OVER THE NEXT SEVERAL YEARS. THE EMB ESTIMATES AS A ROUGH ORDER OF MAGNITUDE THAT FOREIGN EXCHANGE OUTFLOWS RESULTING FROM COMPENSATION WILL BE ON THE ORDER OF US\$25 TO 40 MILLION ANNUALLY FOR THREE TO FIVE YEARS.

5. ANOTHER LIKELY IMPACT ON ETHIOPIA'S FOREIGN EXCHANGE POSITION IS THE GOVT'S SHARPLY INCREASED DEVELOPMENT EXPENDITURES. THE CAPITAL BUDGET (ETHIOPIAN FINANCED) INCREASED FROM APPROX US\$40 MILLION UN USFY 74 TO ROUGHLY US\$70 MILLION IN USFY 75. IT APPEARS THAT USFY 76 WILL SEE FURTHER INCREASES BUT PROBABLY NOT AT THE SAME RATE. THE FOREIGN EXCHANGE IMPACT OF THESE INCREASES IS DIFFICULT TO JUDGE BUT SOONER OR LATER THERE WILL BE INCREASED DEMAND FOR IMPORTED GOODS - SOONER IN THE CASE OF CAPITAL AND INTERMEDIATE GOODS AND LATER (OR POSSIBLY NOT AT ALL IF RIGOROUS CONTROLS ARE APPLIED) IN THE CASE OF CONSUMER GOODS. CONSEQUENTLY, THE EFFECTS ON ETHIOPIA'S FOREIGN EXCHANGE WILL PROBABLY BE MORE PRONOUNCED TOWARD THE END OF THIS PERIOD.

6. TO SUM UP, NOT ONLY HAS THE EPMG'S APPETITE FOR MILITARY HARDWARE AND SERVICES BEEN INCREASING, BUT IT HAS ALSO INCURRED OBLIGATIONS FOR THE COSTS OF NATIONALIZATION AND INCREASED DEVELOPMENT EXPENDITURES. WHILE ITS BOP WILL PROBABLY HOLD UP OR COULD EVEN IMPROVE SLIGHTLY IN THE SHORT RUN, THESE DEMANDS, IN THE LONGER RUN, SHOULD PUT CONSIDERABLE PRESSURE ON ETHIOPIA'S BOP AND FOREIGN EXCHANGE RESERVES.

7. THE IMPACT OF THE EPMG'S PROPOSED PROCUREMENT ALSO HAS SERIOUS IMPLICATIONS FOR ETHIOPIA'S INTERNAL POSITION. IT SEEMS CLEAR THAT TH
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EPMG WILL EMPLOY DEFICIT FINANCING TO OBTAIN THE ETHIOPIAN DOLLARS IT NEEDS TO BUY THE FOREIGN EXCHANGE WHICH WILL IN TURN BE USED FOR MILITARY PROCUREMENT AND, AS POINTED OUT IN OUR PREVIOUS ANALYSIS, ETHIOPIA HAS CONSIDERABLE ROOM FOR USE OF THIS TECHNIQUE WITHOUT INCURRING UNDUE INFLATIONARY RISKS OR AN UNMANAGEABLE DEBT SERVICING REQUIREMENT (SEE REFS). BUT IF THE DEMANDS OF A GREATLY INCREASED DEVELOPMENT PROGRAM AND COMPENSATION FOR NATIONALIZED ENTERPRISES ARE ADDED TO THOSE FOR MILITARY PROCUREMENT, INFLATIONARY PRESSURES, IF NOT DEBT SERVICING, COULD BECOME A MAJOR PROBLEM IN THE LONG RUN. UNTIL THE COMPENSATION DECREE IS ISSUED AND AGREEMENTS WITH NATIONALIZED ENTERPRISES ARE AVAILABLE AND UNTIL THE EPMG FY 68 (US FY 76) BUDGET IS ANNOUNCED, IT WILL NOT BE POSSIBLE TO QUANTIFY THESE EFFECTS. IN ADDITION, THEIR INFLATIONARY IMPACT DEPENDS HEAVILY

ON HOW THE EPMG DECIDES TO FINANCE THESE DEFICITS AND THE ATTITUDES OF THE PUBLIC TOWARD SAVING (SEE REFTEL). IT IS, THEREFORE, STILL TOO SOON TO BE ABLE TO CARRY OUT AN ADEQUATE ANALYSIS OF THIS ASPECT OF INCREASED GOVT EXPENDITURES. BASED ON CURRENT INDICATIONS, HOWEVER, THE EMB BELIEVES THAT THESE EXPENDITURES COULD WELL SET IN TRAIN STRONG INFLATIONARY PRESSURES.

8. IMPLICATIONS AND CONCLUSIONS. FROM THE FOREGOING ASSESSMENT, IT APPEARS THAT THE EPMG HAS INCREASED THE RISK OF DISSIPATING ITS FOREIGN EXCHANGE RESERVES AND CREATING UNMANAGEABLE INFLATIONARY PRESSURES OVER THE LONGER RUNS ASSUMING IT PURSUES PROJECTED LEVELS OF MILITARY PROCUREMENT, COMPENSATES NATIONALIZED FIRMS AT REASONABLE LEVELS AND CONTINUES TO INCREASE ITS SELF-FINANCED DEVELOPMENT BUDGET. THESE DANGERS, WHILE NOT IMMEDIATE, ARE REAL AND SERIOUS. IT SHOULD ALSO BE BORNE IN MIND THAT, AS THE EPMG'S MILITARY PROCUREMENT ACTIONS BECOME PUBLICLY KNOWN, THE RISK OF DISENCHANTING ITS MAJOR AID DONORS (WORLD BANK, USAID) INCREASES, WHICH, IN TURN, COULD RESULT IN REDUCED CONCESSIONAL AID INFLOWS. THE EPMG FACES SOME BASIC ECONOMIC CHOICES OVER THE NEXT SEVERAL MONTHS WHICH, FOR BETTER OR WORSE, WILL HAVE A STRONG INFLUENCE ON THE ECONOMIC COURSE OF THE COUNTRY FOR SEVERAL YEARS TO COME. THESE CHOICES WILL BE MADE ALL THE MORE TREACHEROUS BECAUSE ETHIOPIA'S STRONG SHORT RUN POSITION MAY INDUCE THE EPMG TO COMMIT ITSELF TO MORE (OF EVERYTHING) THAN IT CAN, IN THE LONGER RUN, AFFORD.

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